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C O N F I D E N T I A L SECTION 01 OF 02 TEGUCIGALPA 001845

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SUBJECT: HONDURAS: IMF VERY PLEASED WITH GOH PERFORMANCE TO  
DATE

REF: A) TEGUCIGALPA 0600

Classified By: Classified By: Economic Chief Patrick Dunn for reasons 1  
.4 (b) and (d).

1. (C) On September 2, an International Monetary Fund (IMF) team completed its two-week long review of GOH macroeconomic policies. Team Leader Luis Breuer told Charge that the GOH is slightly outperforming its assigned fiscal and monetary targets and the Fund is very pleased with what they have seen to date. This performance is particularly impressive given the sharp rise in fuel prices recently and the temptation for the GOH to lose fiscal discipline as the November 27 elections approach. Breuer noted that the GOH has held firm in resisting strong political pressures to exceed spending caps to better position the ruling National Party for the upcoming elections. (Note: Post has previously commented on the very hard line Minister of Finance William Chong Wong has taken, refusing any new proposed spending that is not explicitly offset by new revenue or spending cuts elsewhere. End note.)

2. (C) After reviewing the GOH's books, the Fund privately confirmed to Post that there is still some money available for the GOH to complete many of its projects such as port improvements and anti-poverty projects. Despite this buffer funding, the GOH continues to tell petitioners that there is no money left. Complicating the GOH financial outlook is an IMF-imposed spending cap on investments for CY 2005. The GOH has complained on numerous occasions that this cap threatens to make it impossible for the GOH to access even concessional funding for important social spending programs such as school infrastructure rehabilitation. Post raised this issue with IMF ResRep Hunter Monroe and with World Bank ResRep Adrian Fozzard. After considering the GOH's argument, Breuer reported that the IMF believes that the GOH should invest about \$100 million more on capital spending. The Fund will engage in a negotiation with the GOH to reach an agreement on an investment plan covering the rest of this year.

3. (C) The team also met with both leading presidential candidates, Liberal Party candidate Mel Zelaya and National candidate Porfirio "Pepe" Lobo, to discuss fiscal responsibility. The Fund was favorably impressed with both. The Fund met with both last March in a quasi-secret meeting in Miami (ref A) to secure their agreement to abide by the terms of the Poverty Reduction and Growth Facility (PRGF) and to request the candidates refrain from politicizing the Fund agreement during the campaign (which would make it much harder for the next government to implement). That said, the Fund recognizes it will also need to negotiate the next program with the new government.

4. (C) A few issues of particular concern remain. The Fund is acutely aware of the political difficulties that will face the new government in implementing wage reforms for the powerful teachers union, which must be completed by 2007 under the current agreement with the Fund. The Fund is also wary of some of the more populist proposals coming from the campaigns. For example, Pepe Lobo has proposed eliminating a fuel surcharge on electricity bills, which would create an estimated 300 to 600 million lempira (USD 16 to 32 million) hole in the budget annually. The Fund considers this proposal "a very bad idea." Manuel "Mel" Zelaya, also under pressure to propose solutions to the problem of sharply rising energy prices, has proposed cutting fuel taxes, one of the primary sources of revenue for the GOH, and one that will become increasingly important as revenues from customs duties dry up when CAFTA is implemented. Zelaya recognizes that offsetting cuts must be identified to fund such a proposal, but to date has not suggested where those (substantial) cuts would come from. Each of these proposals is additional to the existing targeted subsidy for electricity and for mass transportation that benefits the poorest Hondurans (defined as those that use less than 300 kilowatts). This subsidy is already included in the budget and has been approved by the Fund. Recognizing the political pressures brought about by rapidly rising prices, the Fund concedes that there is some prospect of increasing the electricity subsidy to the poor and is working with the GOH on this.

15. (C) ResRep Monroe told Post that initial figures suggest remittances to Honduras have risen an astonishing 53 percent year-on-year to approximately USD 1.5 billion, a figure he said he cannot yet explain. Remittances throughout the Central American region have been growing by approximately 25 percent per year for the last several years. Conventional wisdom attributes this rise to higher numbers of Honduran and other Central American emigrants, improved earning power in the U.S., and overall economic recovery in the U.S. All of these factors combined, however, seem insufficient to explain this year's projected jump in remittances. (Note: There is a significant Honduran expatriate population in New Orleans -- variously estimated at up to 150,000 -- that was hard hit by hurricane Katrina. This could reduce remittance inflows this year by USD 100 million or more, and could potentially result in reverse flows for a short time as Hondurans seek to assist their relatives in the U.S. However, even this socio-economic catastrophe and its attendant drop in remittances is dwarfed by the USD 400 million projected increase in total remittances this year alone. End note.)

16. (C) These remittances are increasingly routed through safer and less expensive formal transmission channels, rather than via relatives or hawala-type arrangements. Once received in a Honduran bank, the Central Bank of Honduras (BCH) imposes a 100 percent surrender requirement on these dollars nightly. To prevent the lempira issued for these surrendered dollars from sparking inflation, the BCH sterilizes the flows by issuing absorption certificates (known as CAMs), which currently yield 11.5 percent. The result has been a stable single-digit inflation rate (8.6 percent year on year as of July), but a rapid accumulation of forex reserves (estimated at about 5 months of import cover and rising). The interest rate differential between the CAMs and dollar-denominated instruments has resulted in a large quasi-fiscal deficit for the BCH, which the GOH seeks to eliminate by moving all bond issuance activities to the Ministry of Finance and limiting the BCH role to money-desk operations (for liquidity management and interest-rate signaling).

17. (C) Liberal candidate Mel Zelaya has proposed eliminating the CAMs as a way of increasing liquidity to the system, to ease the credit crunch in the rural sectors. President of the Foundation for Investment and Export Development and former Vice Minister of Finance Vilma Sierra de Fonseca told EconChief that this plan is terribly risky, as it would expose the economy to intense inflationary pressures. The long term solution, she said, is a more flexible exchange rate mechanism. (Note: IMF ResRep Monroe made similar comments separately to EconChief.) That will take some time, she said, and when it happens, the lempira -- which has been depreciating slowly relative to the dollar (in nominal terms) for several years -- will need to appreciate. Former Minister of Trade and current Ambassador to the U.S. Norman Garcia made similar comments to EconChief in July before departing for his Washington assignment. (Note: The exchange rate is currently a managed float, pegged to a trade-weighted basket of currencies, overwhelmingly the U.S. dollar. The currency depreciated 4.4 percent relative to the dollar last year in nominal terms, and is expected to depreciate an additional 2.5 percent this year. The lempira settled at 18.87 to one USD last week, down slightly from the previous week's 18.86 to one. End note.)

18. (C) Comment: This is as positive a review as Post has heard from the IMF in quite some time, and is particularly welcome in this election season. Post shares the Fund's satisfaction that the GOH has thus far avoided inflationary pressures from energy cost spikes and sharp increases in remittance inflows, and has resisted the temptation to forego fiscal discipline in the run-up to the November 27 elections. We will continue to watch closely, both as the elections approach, and as the GOH begins to appropriate an estimated USD 212 million in savings from HIPC debt service forgiveness this year. End Comment.

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